

REPORT OF EXAMINATION
OF THE
TIG INSURANCE COMPANY

AS OF
DECEMBER 31, 2005

Participating States
and Zones:

California
Delaware, Zone 1 – Northeastern

Filed June 28, 2007

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Los Angeles, California
May 29, 2007

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Kent Michie
Secretary, Zone IV-Western
Commissioner of Insurance
Department of Insurance, State of Utah
Salt Lake City, Utah

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Honorable Thomas E. Hampton
Secretary, Zone I-Northeastern
Commissioner of Insurance
Department of Insurance, Securities and Banking
Washington, D.C.

Dear Chairman, Secretaries and Commissioners:

Pursuant to your instructions, an examination was made of the

TIG INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 250 Commercial Street, Suite 5000, Manchester, New Hampshire 03101. The Company's statutory home office and main administrative office is located at 8880 Rio San Diego Drive, Suite 510, San Diego, California 92108.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2002. This examination covers the period from January 1, 2003 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. An examiner from Delaware, representing Zone I-Northeastern of the NAIC, participated in the examination. The examination included a review of the Company's practices and procedures, an

examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; and sales and advertising.

This examination was conducted in conjunction with the examination of the Company's wholly - owned subsidiaries, TIG Indemnity Company, TIG Specialty Insurance Company, Fairmont Premier Insurance Company, and Fairmont Insurance Company.

SUMMARY OF SIGNIFICANT FINDINGS

As a result of this examination, surplus as regards policyholders as of December 31, 2005 has been reduced by \$ 164.2 million. The reduction in surplus was due to decreases in the admitted value of affiliated common stocks, and increases in the Company's losses and loss adjustment expense reserves.

SUBSEQUENT EVENTS

During the 4th quarter of 2006, the Company and its primary operational services provider, RiverStone Resources LLC (Riverstone), began implementing a restructuring plan whereby most workers' compensation claims were outsourced to a non-affiliated third party administrator (Risk Enterprise Management) to handle the Company's workers' compensation claims. Three of the Company's claims offices were closed. In addition, the plans call for various support functions to be scaled back, resulting in further downsizing of the Company and Riverstone's staff. Riverstone, however, continues to provide management services to the Company.

On March 8, 2007, the California Department of Insurance approved the Company's request to pay an extraordinary dividend in the amount of \$124,832,093 to its sole shareholder, TIG Insurance Group, Inc., which in turn will distribute the proposed amount to its sole shareholder, Fairfax, Inc. The assets subject to this dividend were three promissory notes totaling \$122.5 million, due from Fairfax, Inc., maturing June 30, 2007, plus accrued interest. See Company History for further detail on these affiliated notes receivable.

COMPANY HISTORY

On December 16, 2002, the California Department of Insurance (CDI) approved the merger of the Company with International Insurance Company of Illinois (IIC). IIC had been in runoff since 1992. TIG Insurance Group, Inc. (TIG Group), the immediate parent of the Company, had acquired 100% of the outstanding shares of IIC. The Company and IIC then merged, with the Company being the surviving entity.

Discontinued operations: On December 16, 2002, Fairfax Financial Holdings Limited (Fairfax), the Company's ultimate parent, announced the decision to discontinue the operations and to run off the existing book of business written by the Company and its subsidiaries. Company management, feeling that the Company was substantially over-capitalized for the circumstances of a runoff operation, petitioned the CDI to allow it to dividend certain assets, to its parent.

On January 6, 2003, the CDI approved three extraordinary dividends payable by the Company to its parent, TIG Group. The dividends were in the form of securities representing: 100% of the outstanding common stock of Ranger Insurance Company; 100% of the outstanding common stock and preferred stock of Commonwealth Insurance Company (which was subsequently exchanged for equal value of common stock in Northbridge Financial Corporation (Northbridge); and 33.2 million shares of the stock of Odyssey Re Holdings Corporation (ORHC), representing approximately 51% of such company's total outstanding voting stock. The statutory value of the extraordinary dividends was approximately \$600 million. The extraordinary dividends were subject to deposit in a trust and the meeting of certain conditions before withdrawal by the parent company could be accomplished.

The Trust: The securities included in the extraordinary dividend had been placed in a trust (hereinafter known as The Trust) at Bank of New York, with the Company as beneficiary. The Trust contents, until removed, served as collateral for Fairfax's guarantee obligations to the Company, including cessions under the following described Adverse Development Cover (ADC).

The approval of the above extraordinary dividends by the CDI was subject to certain conditions including the following:

- 1) The replacement of the following ADC agreement with nSpire Re Limited (nSpire), by an identical ADC agreement with a non-affiliated carrier. nSpire is an affiliated company not authorized in the State of California.

Note that as of December 31, 2002 the Company ceded \$100 million in losses to nSpire pursuant to the ADC. Additionally at that time the nSpire ADC provided up to an additional \$300 million reinsurance coverage for future adverse development to the Company's carried net reserves as of December 31, 2002, bringing the total potential cession under the treaty to \$400 million.

In September 2003, as a result of the placement of up to a \$300 million portion of the nSpire ADC with a new treaty with Federal Insurance Company (Federal), a member of the Chubb Group of Insurance Companies, the CDI allowed all of the common stock of Northbridge to be removed from The Trust, as well as 4.8 million shares of ORHC common stock. The ORHC common stock was contributed back down to the Company as reimbursement for the cost of the treaty with Federal.

Concurrent to the Federal ADC, the nSpire ADC agreement was amended to provide protection to the Company for those portions of the original ADC not covered by the Federal replacement ADC.

2) Fairfax guaranteed that the Company should maintain a surplus of at least \$500 million through December 31, 2003.

3) Fairfax guaranteed that the Company's ratio of surplus to authorized control level for Risk Based Capital (RBC) purposes should be at least 200% beginning with December 31, 2002.

4) Fairfax guaranteed that the Company should maintain a net statutory reserve to surplus ratio of 3 to 1 or less beginning December 31, 2002.

5) Fairfax guaranteed to the Company the performance of claims handling services by Third Party Administrators (TPA's) to whom prepayment had been made and for which claims handling expense reserves had been released.

On April 27, 2004, as a result of the Company's compliance with certain financial requirements as of December 31, 2003, the CDI allowed the Company to release all but \$200 million of the assets included in The Trust.

During December 2005, as a result of the Company's compliance with the remaining financial and transactional requirements, the CDI allowed the release of all remaining assets from The Trust, as well as the dissolution of The Trust.

Fairfax formed a new holding company under the name of Fairmont Specialty Group, Inc. (FSG) during 2003. The primary purpose of forming FSG was to underwrite certain insurance business (Hawaii personal and commercial lines, and New Jersey accident and health lines of business) that was being conducted by the Company and its insurance subsidiaries prior to discontinuing operations. FSG was to manage a subgroup of companies within the Fairfax Group and separate from the discontinued operations of the Company.

FSG was formed through a series of dividends of all of the outstanding common shares of the following subsidiaries of the Company; TIG Premier Insurance Company (Premier) - which during

2004 was renamed Fairmont Premier Insurance Company, Fairmont Insurance Company (Fairmont), and Ranger Insurance Company (Ranger) - which during 2004 was renamed Fairmont Specialty Insurance Company. Effective January 1, 2004, a re-alignment took place in which Premier became a direct wholly owned subsidiary of FSG, while Fairmont and Ranger became direct wholly-owned subsidiaries of Premier.

Effective December 31, 2003, Premier and its affiliate, Fairmont, commuted their 100% quota-share reinsurance agreement with the Company and immediately entered into an agreement whereby they transferred 100% of their gross losses and loss adjustment expenses and unearned premium reserves to the Company which totaled \$302 million for Premier and \$237 million for Fairmont. Premier and Fairmont remain contingently liable for the claims relating to the reserves sold. The CDI approved the transfer of reserves as a permitted practice whereby all direct reserves as of December 31, 2003 have been removed from the books and records of Premier and Fairmont and are now reflected as direct reserves of the Company.

Effective January 1, 2004, with the approvals of the CDI, Premier and Fairmont declared respectively \$15.9 million and \$8.5 million extraordinary dividends to its former parent, the Company. Following these dividends, the Company contributed to Premier 100% of the issued and outstanding shares of Fairmont. The Company then distributed Premier to TIG Insurance Group (the Company's immediate parent and owner of FSG). TIG Insurance Group then proceeded to further contribute Premier (including subsidiary Fairmont) to FSG and to contribute Ranger to Premier as well. This distribution (booked as a stockholder dividend) resulted in a decrease in TIG surplus of \$41 million.

This group of Fairmont companies (by now known as Fairmont Premier Insurance Company, Fairmont Insurance Company, and Fairmont Specialty Insurance Company) actively wrote and retained the aforementioned Hawaii and New Jersey segments of business during years 2004 and 2005. In the reinsurance section of this report is a discussion of the treaties established to facilitate the premium writings and transfer of business to FSG companies.

On December 23, 2005, FSG was sold to the Company along with all of FSG's subsidiary companies including Fairmont Premier Insurance Company, Fairmont Insurance Company and Fairmont Specialty Insurance Company. Pursuant to this restructuring the Company exchanged 7,744,125 shares of common stock of publicly traded affiliate Odyssey Reinsurance Holding Corporation (ORHC) for 100% of the affiliated FSG shares. The total purchase price was stated at \$138.4 million, which approximated the statutory surplus of the FSG shares acquired. There was no goodwill recorded as a result of this transaction. The CDI approved this transaction on December 22, 2005.

On December 28, 2005, Fairfax announced that, effective January 1, 2006, the Fairmont Specialty Group of Companies (under FSG) would be placed into run-off and that subject business would subsequently be carried on as the "Fairmont Specialty Division" of the affiliated Crum & Forster group of companies. Pursuant to the "Restructuring Plan for Fairmont Specialty Group December 2005" it is the stated intention that Crum & Forster Holding, Inc. (C&F) insurance subsidiaries, including United States Fire Insurance Company (U.S. Fire) will ultimately write the new and renewal FSG business. However, FSG business can not be written by C&F insurers immediately in some jurisdictions due to rate and form filing requirements and certain C&F insurers need to be licensed for additional lines of insurance in some states. For these reasons the business on a go-forward basis continues to be written by the FSG companies and is then 100% reinsured with U.S. Fire.

FSG and its insurance subsidiaries entered into agreements with U.S. Fire to reinsure the business, to perform the necessary business functions including claims administration, and to transfer the business assets and personnel.

Effective December 31, 2003, TIG Group, the Company's immediate parent, contributed to the Company 100% of the issued and outstanding common stock of Old Lyme Insurance Company of Rhode Island, Inc., an affiliate of the Company placed into runoff in 2003, resulting in an increase in the Company's gross paid-in and contributed surplus by \$39 million. This transaction was approved by the CDI.

Effective December 31, 2003, three of the Company's subsidiaries, TIG Insurance Company of Colorado, TIG Insurance Company of Texas and TIG Insurance Corporation of America were merged into the Company. All three of the merged companies had 100% quota-share reinsurance agreements with the Company. These mergers were approved by the CDI.

Effective January 16, 2004, the CDI approved the merger of the Company's wholly-owned subsidiary, TIG Insurance Company of New York (TIGNY), with the Company. TIGNY had a 100% quota-share reinsurance agreement with the Company.

On April 28, 2004, TIG Lloyds Insurance Company (TIG Lloyds), an affiliate of the Company, was dissolved with the Company assuming all the assets and liabilities of TIG Lloyds.

Effective October 31, 2004, two of the Company's wholly-owned subsidiaries, TIG Insurance Company of Michigan, and TIG American Specialty Insurance Company were merged into the Company. Both of the merged companies had 100% quota-share reinsurance agreements with the Company. These mergers were approved by the CDI.

On February 16, 2006, the Company and Fairfax, Inc. formalized an agreement that the Company would sell one million shares of the affiliated Odyssey Re Holdings Corp (ORHC) common stock to Fairfax, Inc. at a price of \$25.08 per share, which was the closing market price at December 30, 2005. The proceeds from the sale were received by the Company prior to the filing of the 2005 Annual Statement. The Company received a permitted accounting practice from the CDI to record this sale effective December 31, 2005.

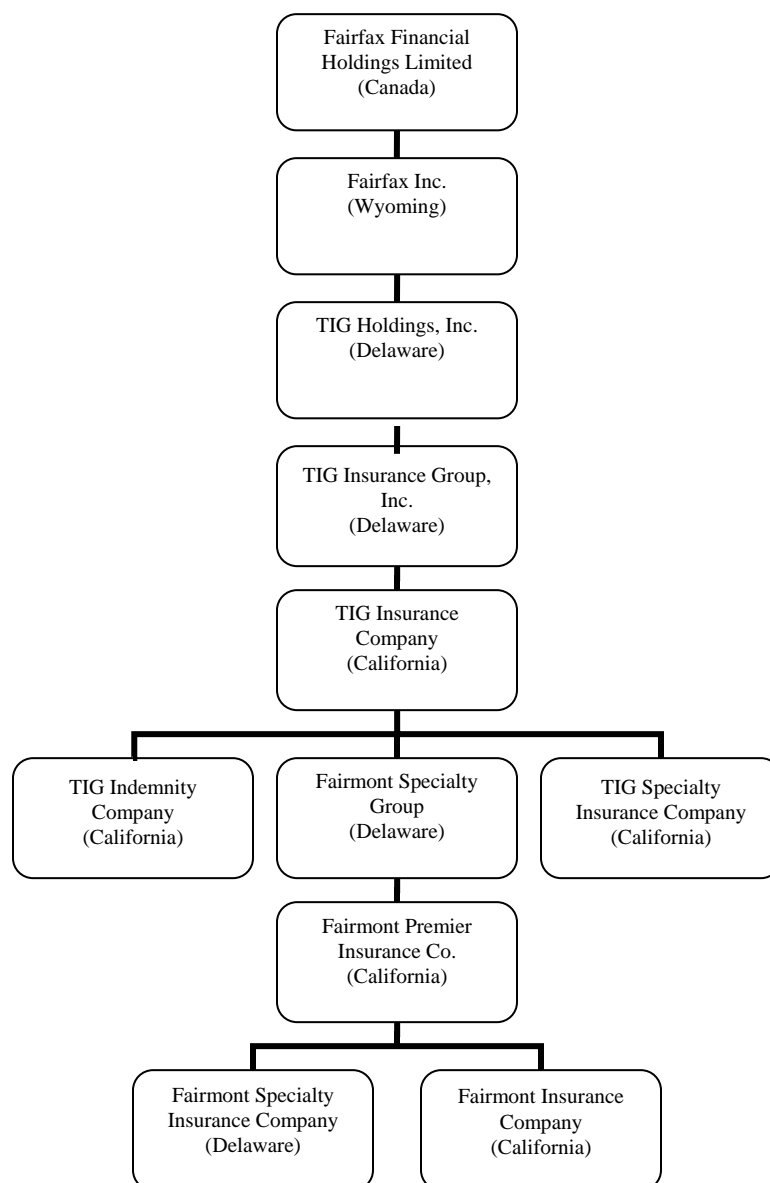
Effective September 30, 2005 the CDI approved a deferral of the final principal payments, of two notes, totaling \$100 million, that were due to the Company from Fairfax, Inc. from June 30, 2006 to June 30, 2007. In conjunction with this deferral, the CDI also approved the execution of an additional note valued at \$22.5 million with similar terms.

On September 7, 2005, Fairfax received a subpoena from the Securities Exchange Commission (SEC) requesting documents regarding any non-traditional reinsurance or reinsurance product

transactions entered into, or offered, by the entities in the consolidated group. On September 26, 2005, Fairfax received a further subpoena from the SEC as part of its investigations into such loss mitigation products, requesting documents regarding any transactions in the Company's securities, the compensation for such transactions and the trading volume or share price of such securities. Fairfax understands that the U.S. Attorney's office for the Southern District of New York is reviewing information that Fairfax provides to the SEC in response to SEC subpoenas. Earlier, on June 24, 2005, Fairfax's FSG had received a subpoena from the SEC requesting documentation regarding any non-traditional insurance products entered into by FSG's insurance subsidiaries with General Re Corporation or affiliates. Fairfax is cooperating fully with these requests.

MANAGEMENT AND CONTROL

The following abridged organizational chart, which is limited to the Company's parent along with its subsidiary insurance companies, depicts the Company's relationship within the holding company system as of December 31, 2005:



All ownership is 100%.

Management of the Company is vested in a five-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2005 follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Richard S. Donovan South Lake, Texas	President TIG Insurance Company
Charles G. Ehrlich Amherst, New Hampshire	Senior Vice President TIG Insurance Company
Dennis C. Gibbs Bedford, New Hampshire	Chief Executive Officer TIG Insurance Company
Robert L. Gossett Seabrook, New Hampshire	Senior Vice President TIG Insurance Company
Michael J. Sluka Hooksett, New Hampshire	Chief Financial Officer TIG Insurance Company

Principal Officers

<u>Name</u>	<u>Title</u>
Richard S. Donovan (*)	President
John M. Parker	Senior Vice President and Secretary
Michael J. Sluka	Senior Vice President and Treasurer
Frank J. DeMaria	Senior Vice President
Charles G. Ehrlich	Senior Vice President
Robert D. Warren	Senior Vice President
Henry W. Edmiston	Senior Vice President
Robert L. Gossett	Senior Vice President

(*) Replaced by William J. Gillett effective August 16, 2006

Management Agreements

Tax allocation agreement: The Company is party to a tax allocation agreement with TIG Holding, Inc., dated January 1, 2000, whereby it files its' federal income taxes on a consolidated basis along with 50 other affiliated companies. Each company computes its' federal income tax liability or

refunds on a separate basis and settles with its parent. The California Department of Insurance (CDI) approved the agreement on January 1, 2001. The Company's portion of the federal income taxes incurred for 2003, 2004, and 2005, were \$374,000, \$(353,000), and \$173,000, respectively.

Investment Agreement: The Company is party to an agreement with Hamblin Watsa Investment Counsel Ltd. (HWIC), and Fairfax Financial Holdings Limited (Fairfax) effective January 1, 2003. Pursuant to the agreement, HWIC manages the investments of the Company in accordance with specific investment objectives outlined in the agreement. All fees are paid by the Company, to Fairfax, and Fairfax reimburses HWIC for investment management services. HWIC is a subsidiary of Fairfax. The CDI approved the agreement on December 3, 2003. For 2003, 2004, and 2005, fees paid by the Company were \$1,851,000, \$2,988,000, and \$3,399,000, respectively.

Information Technology Services Agreement: The Company was party to an agreement with the affiliated Fairfax Information Technology Services, Inc. (FITS) initially effective August 1, 2001 and amended effective January 1, 2004. Pursuant to this written agreement FITS is authorized to manage and provide information technology services to the Company. The CDI approved the initial agreement on September 17, 2001 and the amendment on November 16, 2005. For 2003, 2004, and 2005, fees paid by the Company were \$8,713,000, \$6,260,000, and \$6,263,000, respectively.

Service Contract and Expense Sharing Agreement: The Company has a Service Contract and Expense Sharing Agreement effective January 1, 1994, with TIG Holdings, Inc. The agreement applies to all shared functions of the two companies. It does not apply to allocated claims expenses, fees for maintaining investment management services nor to federal income taxes. This agreement is for all personnel and personnel service requirements, all home and service office space, supplies, business equipment and all other requirements for the conduct of business of the respective parties that may be provided by the Company. The CDI approved the agreement on June 20, 1994. Although management indicates it is currently in effect the Company paid no fees under this agreement during the examination period.

Services Agreement: An ongoing Services Agreement, effective August 11, 1999, between RiverStone Resources LLC (RiverStone Resources) and the former International Insurance

Company of Illinois (IIC) continued in effect during the period covered by this examination. The Company became a party to this agreement as a result of the December 2002 merger between IIC and the Company. Since IIC has been merged into the Company it is recommended that this agreement be amended to include the Company as a named party to the agreement. Services provided included financial services, human resources, legal services, and various other services necessary for the daily operations of the company. For 2003, 2004, and 2005, fees paid by the Company were \$16,190,000, \$14,161,000, and \$17,136,000, respectively.

Services Agreement: An ongoing Services Agreement, effective January 4, 2000, between RiverStone Claims Management LLC (RiverStone Claims) and International Insurance Company of Illinois (IIC) continued in effect during the period covered by this examination. The Company became a party to this agreement as a result of the December 2002 merger between the Company and IIC. This agreement was terminated effective April 15, 2006, with the servicing of the IIC business to be subsequently handled by RiverStone Claims pursuant to a Claims Service and Management Agreement between the Company and RiverStone Claims, effective December 31, 2000. For 2003, 2004, and 2005, fees paid by the Company were \$9,909,000, \$9,772,000, and \$8,455,000, respectively. These fees were also included the fees paid under the agreement mentioned below.

Claims Service and Management Agreement: The Company has a Claims Service and Management Agreement effective December 31, 2000, with RiverStone Claims. RiverStone Claims is providing claims managerial services for the Company on a cost reimbursement basis. Fees paid pursuant to this agreement are included in the totals for the aforementioned Services Agreement, effective January 4, 2000. The CDI approved the agreement on December 26, 2000.

Reinsurance Service Agreement: Concurrent to the aforementioned Claims Service and Management Agreement, the Company also entered into a Reinsurance Service Agreement effective December 31, 2000, with RiverStone Reinsurance Services LLC which is providing reinsurance collection services for the Company on a cost reimbursement basis. For 2003, 2004, and 2005, fees paid by the Company were \$4,018,000, \$4,326,000, and \$4,810,000, respectively.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2005, the Company was licensed to transact multiple lines of property and casualty insurance and is admitted in all 50 states and the District of Columbia.

The gross premiums written by the Company during the most recent five-year period were as follows:

<u>Year</u>	<u>Premiums</u>
2001	\$1,451,680,434
2002	1,044,253,997
2003	487,923,042
2004	58,384,836
2005	14,532,700

As discussed more fully in “Company History”, the Company announced its intentions to enter into an orderly runoff in late 2002. Because of contractual requirements with certain Managing General Agents (MGA’s) and Managing General Underwriters (MGU’s) the Company continued to write substantial amounts of business throughout 2003.

Prior to discontinuing operations, the Company and its subsidiaries offered reinsurance, personal lines, workers’ compensation and commercial products, primarily throughout the United States and Canada. Premium was generated through brokers and independent agents, who also represented other insurers, and a limited number of general agents.

LOSS EXPERIENCE

The Company reported operating and net losses in all years under examination as follows:

Year	Net Operating Gain or (Loss)	Net Income Or (Loss)
2002	\$ (266,917,152)	\$ (114,832,032)
2003	(222,389,776)	(13,620,803)
2004	(99,591,420)	(139,926,482)
2005 (*)	(334,340,367)	(179,282,734)

(*) not including examination adjustments

It is noted that significant amounts of the Company's net operating losses and net losses during 2004 and 2005 resulted from the commutations of certain material ceded excess of loss reinsurance treaties, see the reinsurance section of this report. It should be noted that net operating losses and net losses in 2005 as a result of this examination are \$ 489,815,367 and \$ 334,757,734, respectively.

REINSURANCE

As of December 31, 2005 all of the Company's assumed and ceded reinsurance treaties were in runoff.

Assumed

Business assumed from affiliates represented roughly 48% of the total \$381 million of assumed case loss and loss adjustment expense reserves at December 31, 2005. The more significant affiliated assumed reinsurance payables resulted from 100% quota-share treaties with affiliates TIG Specialty Insurance Company and TIG Indemnity Company. Relatively material assumed case loss and loss adjustment expense reserves payable to non-affiliates included \$40.2 million to the National Workers' Compensation Reinsurance Plan, \$23.5 million to Virginia Surety Company, Inc., \$19.5 million to Houston General Insurance, and \$17.4 million to First State Insurance Company.

Ceded

The Company has a very complex reinsurance ceded program, involving over 600 authorized and unauthorized reinsurers. Many of the reinsurers had several treaties with the Company and there are in excess of 1000 ceded treaties in total. Therefore, the most significant treaties only were reviewed. Although there are no active treaties in place as of the date of this examination, the following schedule is presented to depict the most recently active principal ceded reinsurance program then in effect:

<u>Type of Contract/ Period Covered</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurer's Maximum Limits</u>
Casualty Lines:			
Workers' Comp Excess of Loss Layers 1 to 3 Calendar year 2002	Swiss Reinsurance	\$1 million each occurrence. Plus 5% of reinsured limit	95% of \$1 million excess of \$1 million, \$3 million excess of \$2 million, \$5 million excess of \$5 million, each occurrence
Workers' Comp Excess of Loss Layers 4 to 5 Calendar year 2002	American National, American United Life Insurance Company, London Life Reinsurance Company, Life Insurance Company of North America, Transatlantic Reinsurance Company and various other reinsurers	\$10 million each occurrence.	\$5 million excess of \$10 million, \$10 million excess of \$15 million
Workers' Comp Excess of Loss Layer 6 and 7 Calendar year 2002	Lloyd's Syndicates	\$25 million each occurrence. \$50 million each occurrence	\$25 million excess of \$25 million, \$25 million excess of \$50 million

<u>Type of Contract/ Period Covered</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurer's Maximum Limits</u>
Workers' Comp Excess of Loss Layer 1 Calendar year 2003	nSpire Reinsurance Limited	\$1 million each occurrence	\$5 million excess of \$1 million
Workers' Comp Excess of Loss Layers 2 thru 5 Calendar year 2003	Lloyds Syndicates, Arch Re, Endurance Specialty, Renaissance Re	\$6 million each occurrence	\$4 million excess of \$6 million, \$5 million excess \$10 million, \$10 million excess \$15 million, \$25 million excess \$25 million
Corporate Casualty Clash Excess of Loss Calendar year 2002	XL Reinsurance Company of America (55%) and Odyssey Reinsurance (5%)	\$2 million each occurrence, plus 40% of \$3 million excess of \$2 million	60% of \$3 million excess of \$2 million each occurrence
Corporate Casualty Clash Excess of Loss Layers Calendar year 2002	Various, including XL Reinsurance Company of America, Transatlantic Reinsurance Company, and Swiss Reinsurance America Corporation	\$5 million each occurrence	\$5 million excess of \$5million, \$15 million excess of \$10 million, \$25 million excess of \$20 million
Corporate Casualty Excess of Loss July 1, 2002 thru June 30, 2003	Hannover Re, Arch Reinsurance Company, Ace Tempest Reinsurance, St. Paul Fire and Marine Insurance Company, Odyssey America Reinsurance Company	\$500,000 each and every claim plus \$3 million aggregate deductible	\$500,000 excess of \$500,000 each and every claim, excess of \$3 million aggregate deductible

<u>Type of Contract/ Period Covered</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurer's Maximum Limits</u>
Quota Share Umbrella and Special Risk Business July 1, 2002 thru June 30, 2003	American Reinsurance Company, nSpire Reinsurance Limited, Hannover Re, Arch Reinsurance Company, Ace Tempest Reinsurance USA, St. Paul Fire and Marine Insurance Company, Odyssey America Reinsurance Company	15% quota share up to \$10 million	85% quota share up to \$10 million
PDP Umbrella Quota Share July 1, 2002 thru December 24, 2003	American Reinsurance Company	15% quota share up to \$5 million	85% quota share up to \$5 million
Hawaii Umbrella Quota Share April 1, 2002 thru March 31, 2003	General Cologne Re	20% quota share up to \$5 million	80% quota share up to \$5 million
Quota Share Professional Liability Umbrella October 1, 2001 thru February 1, 2003	XL Reinsurance America, Odyssey America Reinsurance	Primary \$1 million plus 20% quota share of \$5 million umbrella	80% quota share of \$5 million umbrella
Public Transportation 1 st XOL April 1, 2002 thru March 31, 2003	Swiss Reinsurance	\$500,000 per occurrence plus 5% of \$500,000 excess of \$500,000	95% of \$500,000 excess of \$500,000 per occurrence
Public Transportation 2 nd XOL April 1, 2002 thru March 31, 2003	Swiss Reinsurance	\$1 million plus 5% of \$4 million excess of \$1 million per occurrence	95% of \$4 million excess of \$1 million per occurrence

<u>Type of Contract/ Period Covered</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurer's Maximum Limits</u>
Public Entity 1 st XOL August 1, 2002 thru July 31, 2003	Swiss Reinsurance	\$1 million per occurrence	\$5 million excess of \$1 million per occurrence
Public Entity 2nd and 3 rd XOL August 1, 2002 thru July 31, 2003	Hannover Re, Endurance Specialty Ins. Ltd., Brit Insurance Ltd., Converium Re North America, Odyssey America Re, Lloyds Syndicates, Liberty Mutual	\$6 million	\$5 million excess of \$6 million, and \$10 million excess of \$11 million per occurrence
Property Lines:			
Corporate Property First Excess of Loss July 1, 2002 thru June 30, 2003	Various, including American Reinsurance Company, Ace Tempest Reinsurance USA, Hanover Insurance Company, Odyssey America Re. and Partner Reinsurance Company	\$1 million per risk, plus \$1 million annual aggregate, Plus 15% of \$4 million excess of \$1 million	85% of \$4 million excess of \$1 million per risk, up to \$16 million per occurrence
Corporate Property Second Excess of Loss July 1, 2002 thru June 30, 2003	Various, including American Reinsurance Company, Lloyd's Syndicates, Hanover Insurance Company, Liberty Mutual Insurance Company, Partner Reinsurance Company	\$5 million per risk	\$10 million excess \$5 million per risk, up to \$30 million per occurrence
Corporate Property Third Excess of Loss July 1, 2002 thru June 30, 2003	Lloyd's Syndicates, Hanover Insurance Company, Montpelier Insurance Company, Patriot Insurance Company, Odyssey America Reinsurance Company	\$15 million per risk,	\$10 million excess \$15 million per risk up to \$20 million per occurrence

<u>Type of Contract/ Period Covered</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurer's Maximum Limits</u>
Corporate Property Catastrophe First Excess of Loss July 1, 2002 thru June 30, 2003	Lloyd's Syndicates, XL Reinsurance Company of America, Montpelier Insurance Company, Hanover Insurance Company, Odyssey America Reinsurance Company, General Cologne Re., Liberty Mutual Insurance Company	\$15 million per occurrence	\$5 million excess of \$15 million per occurrence
Corporate Property Catastrophe Second Excess of Loss July 1, 2002 thru June 30, 2003	Lloyd's Syndicates, XL Reinsurance Company of America, Hanover Insurance Company, Odyssey America Reinsurance Company, General Cologne Re., Liberty Mutual Insurance Company	\$20 million per occurrence	\$10 million excess of \$20 million per occurrence
Corporate Property Catastrophe Third Excess of Loss July 1, 2002 thru June 30, 2003	Lloyd's Syndicates, XL Reinsurance Company of America, nSpire Re. Limited, Odyssey America Reinsurance Company, General Cologne Re., Liberty Mutual Insurance Company	\$30 million per occurrence	\$20 million excess of \$30 million per occurrence
Healthcare/Medi cal Malpractice:			
Healthcare Professional Liability Quota Share June 1, 2002 thru May 30, 2003	Arch Re 10%, Odyssey Re 10%, nSpire Re 5%	75% quota share of \$500,000 plus % of upper layers	25% quota share up to \$20 million
Healthcare Professional Liability 1 st XOL June 1, 2002 thru May 30, 2003	Transatlantic Re 32.5%, Employers Re 10%	57.5% of \$1.5 million excess of \$500,000	42.5% of \$1.5 million excess of \$500,000

<u>Type of Contract/ Period Covered</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurer's Maximum Limits</u>
Healthcare Professional Liability 2nd XOL June 1, 2002 thru May 30, 2003	Transatlantic Re 30%, Employers Re 10%, Hannover Re 12.5%, Lloyds Syndicates 10%, Lumberman's Casualty 2.5%	35% of \$3 million excess of \$2 million	65% of \$3 million excess of \$2 million
Healthcare Professional Liability 3rd XOL June 1, 2002 thru May 30, 2003	Transatlantic Re 18%, Employers Re 10%, Hannover Re 7.5%, Lloyds Syndicates 22%, Swiss Re 17.5%	25% of \$10 million excess of \$5 million	75% of \$10 million excess of \$5 million
Healthcare Professional Liability 4th XOL June 1, 2002 thru May 30, 2003	Transatlantic Re 18%, Employers Re 20%, Hannover Re 10%, Lloyds Syndicates 18.75%,	33.25% of \$5 million excess of \$15 million	66.75% of \$5 million excess of \$15 million

Effective December 31, 2001, the Company entered into an agreement with an affiliate, nSpire Re Limited (nSpire), whereby the Company transferred \$52.5 million in cash and investments to nSpire in exchange for nSpire's purchase of \$52.5 million of the Company's net loss and loss adjustment expense reserves, representing 100% of the Company's exposure to construction defect claims incurred as of December 31, 2001 in excess of \$47.5 million, which was retained by the Company. This transaction, a sale of reserves rather than reinsurance, was approved by the California Department of Insurance. Fairfax has guaranteed the performance of nSpire with respect to the payment of these claims. Effective December 31, 2005, the Company remains contingently liable for the \$26.8 million estimated unpaid claims obligations sold to nSpire.

Pursuant to the 2003 restructuring, discussed in the Company History section of this report, the Company and the affiliated Fairmont Premier Insurance Company (Premier) executed the following

reinsurance agreements effective January 1, 2004, to facilitate the premium writings of Fairmont Specialty Group, Inc. (FSG) insurance companies:

- a) 100% quota-share reinsurance agreement whereby the Company ceded 100% of the unearned premium reserves relating to the Hawaii and New Jersey ongoing business to Premier.
- b) 100% quota-share reinsurance agreement whereby the Company ceded 100% of the Hawaii and New Jersey ongoing business produced by the Company and its subsidiaries to Premier.
- c) 100% quota-share reinsurance agreement whereby Premier ceded 100% of the runoff business (non-Hawaii and non-New Jersey business) produced by Premier and its subsidiaries to the Company.

Significant Commuted Treaties

Effective December 31, 1992, Ridge Reinsurance Limited (Ridge Re), which was a wholly-owned subsidiary of Xerox Financial Services, provided aggregate excess of loss reinsurance to International Insurance Company of Illinois (IIC). During December 2002 the Company was the survivor of a merger with IIC. Coverage was provided for unfavorable development on all IIC losses and allocated loss adjustment expenses incurred and uncollectible reinsurance charged by the Company occurring on accident years 1992 and prior, in excess of the retention amount of \$1.2 billion. The contract coverage totaled \$578 million, which is net of 15% coinsurance, was not fully utilized at the time of commutation. Effective December 31, 2005 the Company booked the effects of this commutation. Commutation proceeds of \$373.3 million were classified as “other amounts receivable under reinsurance contracts” in the 2005 Annual Statement and were subsequently received on March 1, 2006. Company records stated approximately \$370 million of ceded reinsurance recoverables from Ridge Re immediately prior to the commutation, indicating a \$3 million gain on commutation.

On December 31, 2002 the Company ceded \$100 million in losses to nSpire pursuant to an Adverse Development Cover (ADC). Additionally, at that time the nSpire ADC provided up to an additional

\$300 million reinsurance coverage for future adverse development to the Company's carried net reserves as of December 31, 2002, bringing the total potential cession under the treaty to \$400 million.

On September 30, 2003, the Company entered into a reinsurance agreement with the non-affiliated Federal Insurance Company (Federal), whereby Federal replaced nSpire on a portion of the ADC with Federal assuming the original \$100 million cession of the ADC and providing an additional \$200 million of coverage.

Concurrent to the Federal ADC the nSpire ADC treaty was amended to provide protection to the Company for those portions of the original ADC not covered by the Federal replacement ADC.

Effective June 30, 2005, both the Federal and nSpire ADC treaties were commuted. The Federal ADC was commuted for \$196.9 million against cessions of \$300 million resulting in a loss on commutation of \$103.1 million to the Company. While the nSpire amended ADC treaty was commuted for \$52.1 million against cessions of \$100 million resulting in a loss on commutation of \$47.9 million.

During 2001, three adverse development reinsurance agreements between the Company and nSpire were novated, with a third-party reinsurer (London Life and Casualty Reinsurance Company) assuming the obligations of nSpire. Effective September 30, 2004, the Company commuted these three agreements with the third party reinsurer for proceeds of \$330 million against recoverables of \$362 million resulting in a loss on commutation of \$32 million.

As of December 31, 2005, reinsurance recoverables, for all ceded reinsurance totaled \$2.4 billion or 399% of surplus as regards policyholders. Approximately \$200 million of the above ceded reinsurance recoverables were from affiliated reinsurers, with the remaining \$2.2 billion from nonaffiliated admitted and non-admitted reinsurers.

ACCOUNTS AND RECORDS

The Company in its 2005 Annual Statement incorrectly classified certain outstanding check balances as “drafts outstanding” rather than as a reduction from “cash”. It is recommended for future filings that the Company follow the classification methodology for cash as presented in the Annual Statement Instructions.

At December 31, 2002 the Company incorrectly stated the amount of common capital stock as \$8,400,000. International Insurance Company of Illinois (IIC) was merged into the Company during December of 2002 and IIC’s common capital stock was inadvertently included with the Company’s despite the fact that the Company was the surviving corporation and the IIC common capital stock cancelled. In 2003, the Company corrected the error by making a \$4,200,000 reduction in that account. That reduction, plus an increase that year of \$129,920 for 928 shares issued by the Company in exchange for the contribution of Old Lyme Insurance Company of Rhode Island, Inc., resulted in the \$4,329,920 corrected amount of common capital stock for 2003. The Company’s common capital stock at December 31, 2005 consists of 30,928 shares with a par value of \$140 per share for a total of \$4,329,920.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

Reconciliation of Examination Changes as of December 31, 2005

Statement of Financial Condition
as of December 31, 2005

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 848,559,225	\$	\$ 848,559,225	
Stocks:				
Common stocks	554,287,091	8,796,189	545,490,902	(1)
Cash and short-term investments	189,563,331		189,563,331	
Other invested assets	127,205,788		127,205,788	
Receivables for securities	9,580,000		9,580,000	
Aggregate write-ins for invested assets	41,349,217		41,349,217	
Investment income due and accrued	11,882,226		11,882,226	
Premiums and considerations				
Uncollected premiums and agents' balances in the course of collection	4,561,798	1,296,479	3,265,319	
Reinsurance				
Amounts recoverable from reinsurers	174,396,351		174,396,351	
Funds held by or deposited with reinsured companies	3,465,951		3,465,951	
Other amounts receivable under reinsurance contracts	373,323,000		373,323,000	
Net deferred tax asset	583,496,962	581,686,868	1,810,094	
Electronic data processing equipment	166,537	166,537	0	
Furniture and equipment	512,612	512,612	0	
Receivables from parent, subsidiaries, and affiliates	32,742,428		32,742,428	
Aggregate write-ins for other than invested assets	<u>5,410,403</u>	<u>1,831,737</u>	<u>3,578,666</u>	
Total assets	<u>\$2,960,502,920</u>	<u>\$ 594,290,422</u>	<u>\$2,366,212,498</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$1,347,967,871	(2)
Reinsurance payable on paid loss and adjustment exp			6,381,673	
Loss adjustment expenses			309,520,959	(2)
Commissions payable, contingent commissions			869,111	
Other expenses			37,723,585	
Taxes licenses and fees			6,160,469	
Current federal and foreign income taxes			296,404	
Unearned premiums			24,600,489	
Ceded reinsurance premiums payable			(9,664,915)	
Funds held by company under reinsurance treaties			6,518,593	
Provision for reinsurance			99,927,951	
Drafts outstanding			34,582,106	
Payable to parent, subsidiaries, and affiliates			8,642,034	
Aggregate write-ins for liabilities			<u>59,668,612</u>	
Total liabilities			1,933,194,942	

Statement of Financial Condition
as of December 31, 2005 (continued)

Aggregate write-ins for special surplus funds	\$ 51,828,314	
Common capital stock	4,329,920	
Gross paid-in and contributed surplus	910,171,987	
Unassigned funds (surplus)	<u>(533,312,665)</u>	
Surplus as regards policyholders		<u>433,017,556</u>
Total liabilities, surplus and other funds		<u>\$2,366,212,498</u>

Underwriting and Investment Exhibit
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income

Premiums earned		\$ (20,100,685)
Deductions:		
Losses incurred	\$ 223,924,351	
Loss expense incurred	220,316,392	
Other underwriting expenses incurred	<u>25,473,939</u>	
Total underwriting deductions		<u>469,714,682</u>
Net underwriting loss		(489,815,367)

Investment Income

Net investment income earned	\$ 50,335,792	
Net realized capital gains	<u>91,163,990</u>	
Net investment gain		141,499,782

Other Income

Net gain from agents' or premium balances charged off	\$ 1,214,396	
Aggregate write-ins for miscellaneous income	<u>12,516,777</u>	
Total other income		<u>13,731,173</u>
Net loss before federal income taxes		(334,584,412)
Federal income taxes incurred		<u>173,322</u>
Net loss		<u>\$ (334,757,734)</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2004		\$ 742,027,190
Net loss	\$ (334,757,734)	
Change in net unrealized capital (loss)	(65,108,388)	
Change in net unrealized foreign exchange capital (loss)	(9,737,271)	
Change in net deferred income tax	83,196,122	
Change in nonadmitted assets	(89,783,845)	
Change in provision for reinsurance	87,850,790	
Surplus adjustments: Paid in	<u>19,330,692</u>	
Change in surplus as regards policyholders		<u>(309,009,634)</u>
Surplus as regards policyholders, December 31, 2005		<u>\$ 433,017,556</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

Surplus as regards policyholders, December 31, 2002, per Examination	\$1,011,857,498
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	Gain in Surplus	Loss in Surplus
Net loss	\$	\$ 406,179,627
Change in net unrealized capital gains	148,613,754	
Change in net unrealized foreign exchange capital loss		1,191,850
Change in net deferred income tax	98,331,991	
Change in nonadmitted assets		118,133,483
Change in provision for reinsurance	109,150,200	
Capital changes: Paid-in	129,920	
Surplus adjustments: Paid-in		334,721,638
Dividends to stockholders		74,839,209
Totals	<u>\$ 356,225,865</u>	<u>\$ 935,065,807</u>

Net decrease in surplus as regards policyholders	<u>(578,839,942)</u>
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Surplus as regards policyholders, December 31, 2005, per Examination	<u>\$ 433,017,556</u>
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Reconciliation of Examination Changes
as of December 31, 2005

	<u>Per Company</u>	<u>Per Examination</u>	<u>Surplus Increase (Decrease)</u>	<u>Notes</u>
<u>Assets</u>				
Common stocks	\$ 554,287,091	\$ 545,490,902	\$ (8,796,189)	(1)
<u>Liabilities</u>				
Losses	1,216,860,871	1,347,967,871	(131,107,000)	(2)
Loss adjustment expenses	285,152,959	309,520,959	<u>(24,368,000)</u>	(2)
Net decrease to surplus as regards policyholders			\$ (164,271,189)	
Surplus as regards policyholders, December 31, 2005 per Company			<u>597,288,745</u>	
Surplus as regards policyholders, December 31, 2005 per Examination			<u>\$ 433,017,556</u>	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Common Stocks

The affiliated Fairmont Premier Insurance Company (FPIC) was concurrently examined by the California Department of Insurance (CDI). The surplus as regards policyholders at December 31, 2005, for FPIC, as determined by the CDI, was used in valuing FPIC common stock. This resulted in a reduction of \$8,796,189 in the FPIC common stock admitted value for the purposes of this report.

(2) Losses and Loss Adjustment Expenses

The Company was directed by the CDI, under California Insurance Code Section 733, to retain the actuarial firm of Petit Actuarial Group, LLC (Petit) for the purpose of assisting this examination in determining the reasonableness of the Company's loss and loss adjustment expense reserves. Based on the analysis by Petit and the review of their work by a Casualty Actuary from the CDI, the Company's December 31, 2005 reserves for losses and loss adjustment expenses were determined to be \$155,475,000 deficient.

Company management formally responded to the aforementioned examination-determined loss and loss adjustment expense reserve deficiencies with the following comments:

- (a) "The Company performs semi-annual loss reserve evaluations and adjusts its carried reserves to the best estimate value indicated by each of those valuations. Further, each year-end estimate is reviewed as a component of the annual external financial statement audit and it is a requirement of that process that the Company's best estimate value fall within a range of reasonable actuarial outcomes as independently determined."
- (b) "The Company has been in run-off status since December, 2002, and as a result, no new policy risks have been added since that date except for statutorily or contractually required renewals. As of the date of the examination, the majority of remaining unsettled claim values

pertains to workers compensation indemnity as well as asbestos and environmental hazard coverage. The liability for all unpaid loss and loss adjustment expenses is inherently an estimate and the long duration of these remaining exposures is further dependent on numerous assumptions as to medical costs, changes in law and litigation outcomes over numerous years into the future. As a result, the Company believes the inherent volatility of this estimation process, combined with the fact that even minor variances in selecting future cost components, can result in significant variation in final aggregate liability values even amongst reasonable and diligent revaluations of the same data at the same point in time.”

- (c) “The Company indicates that the examination process did not independently re-perform a ground-up evaluation of the unsettled asbestos and environmental claims of the Company, but rather reviewed and accepted the Company’s evaluation. The Company believes that the examination did not take into account the Company’s own opining actuary’s indicated reserve redundancy of \$26 million for the asbestos and environmental reserve component solely on the basis of the lack of independent verification of this result.”

In addition to the foregoing, Company management indicated it also took the following actions subsequent to the period under examination:

- (d) “As reported in the Company’s 2006 Annual Statement, Schedule P - Part 2 - Summary, the Company subsequently (during 2006) absorbed one-year incurred adverse development in net losses and defense and cost containment expenses for prior accident years (i.e., 2005 and prior) of \$56,665,000.”
- (e) “The Company also maintained an accounting policy during 2006 which did not charge the period’s “adjusting and other” component of loss adjustment costs against the existing reserve for loss adjustment expenses, but rather, took these costs as a direct incurred charge in the 2006 Statement of Income. This action effectively “strengthened” the Company’s 2006 liability for unpaid adjusting and other costs by one additional year’s worth of these costs.”

Company management indicated the following in regard to the fact that the loss and loss adjustment expense reserves are statutorily stated at full-value (undiscounted):

- (f) “While the liability for unpaid/future loss adjustment costs is also inherently an estimate and therefore subject to variation from present estimates, it should be noted that the Company generates significant income from its invested asset base and such future income is anticipated by the Company to be sufficient to absorb any future costs that may prove to be in excess of the existing reserve.”

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management Agreements – Services Agreement (Page 13): Since International Insurance Company of Illinois has been merged into the Company it is recommended that this agreement be amended to include the Company as a named party to the agreement.

Accounts and Records (Page 24): The Company in its 2005 Annual Statement incorrectly classified certain outstanding check balances as “drafts outstanding”, rather than as a reduction from “cash”. It is recommended for future filings that the Company follow the classification methodology for cash as presented in the Annual Statement Instructions.

Previous Report of Examination

Bonds (Page 30): The Company failed to file its affiliated common stock of ORH Holding Inc. and its wholly-owned preferred stock of Commonwealth Insurance Company with the Securities Valuation Office (SVO), pursuant to Part 8, Section 1 and Part 6, Section 3(c)(i) of the Purposes and Procedures Manual of the NAIC SVO, respectively. It was recommended that the Company follow the NAIC SVO regulations in the future. Although requested the Company did not provide documentation evidencing any SVO filing of the common stock of ORH Holding Inc. for 2005. The Company did provide documentation evidencing SVO filings for the remaining affiliated stocks held

at year-end 2005. Note that the Commonwealth Insurance Company preferred stock is no longer owned by the Company.

Receivable/Payable for the Securities (Page 30): The Company incorrectly reported interest receivable/payable on “lines” specifically designated for amounts due from or to brokers, when securities have been sold or purchased but have not as yet settled. It was recommended that the Company follow the Annual Statement Instructions in the future. At December 31, 2005 the Company correctly reported the receivables for securities balances to exclude related interest receivable.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

_____/S/_____
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